



TAX EXEMPT AND  
GOVERNMENT ENTITIES  
DIVISION

DEPARTMENT OF THE TREASURY  
INTERNAL REVENUE SERVICE  
WASHINGTON, D.C. 20224

Number: **201228041**  
Release Date: 7/13/2012

Date: April 20, 2012

Contact Person:

Identification Number:

Contact Number:

Employer Identification Number:

Form Required To Be Filed:

Tax Years:

UIL: 501.32-00; 501.33-00; 501.33-01

Dear :

This is our final determination that you do not qualify for exemption from Federal income tax as an organization described in Internal Revenue Code section 501(c)(3). Recently, we sent you a letter in response to your application that proposed an adverse determination. The letter explained the facts, law and rationale, and gave you 30 days to file a protest. Since we did not receive a protest within the requisite 30 days, the proposed adverse determination is now final.

Since you do not qualify for exemption as an organization described in Code section 501(c)(3), donors may not deduct contributions to you under Code section 170. You must file Federal income tax returns on the form and for the years listed above within 30 days of this letter, unless you request an extension of time to file.

We will make this letter and our proposed adverse determination letter available for public inspection under Code section 6110, after deleting certain identifying information. Please read the enclosed Notice 437, *Notice of Intention to Disclose*, and review the two attached letters that show our proposed deletions. If you disagree with our proposed deletions, you should follow the instructions in Notice 437. If you agree with our deletions, you do not need to take any further action.

In accordance with Code section 6104(c), we will notify the appropriate State officials of our determination by sending them a copy of this final letter and the proposed adverse letter. You should contact your State officials if you have any questions about how this determination may affect your State responsibilities and requirements.

Letter 4038 (CG) (11-2005)  
Catalog Number 47632S

If you have any questions about this letter, please contact the person whose name and telephone number are shown in the heading of this letter. If you have any questions about your Federal income tax status and responsibilities, please contact IRS Customer Service at 1-800-829-1040 or the IRS Customer Service number for businesses, 1-800-829-4933. The IRS Customer Service number for people with hearing impairments is 1-800-829-4059.

Sincerely,

Lois G. Lerner  
Director, Exempt Organizations

Enclosure  
Notice 437  
Redacted Proposed Adverse Determination Letter  
Redacted Final Adverse Determination Letter



DEPARTMENT OF THE TREASURY  
INTERNAL REVENUE SERVICE  
WASHINGTON, D.C. 20224

TAX EXEMPT AND  
GOVERNMENT ENTITIES  
DIVISION

Date: **March 1, 2012**

Contact Person:

Identification Number:

Contact Number:

FAX Number:

Employer Identification Number:

**LEGEND:**

B = Board Member  
C = Board Member  
D = Board Member  
M = Educational Program  
O = State  
P = Publishing Company  
Q = Consulting Company  
R = City  
U = Date of Incorporation  
V = Educational Program  
Y = Percentage Range

**UIL:**

501.32-00  
501.33-00  
501.33-01

Dear :

We have considered your application for recognition of exemption from federal income tax under Internal Revenue Code section 501(a). Based on the information provided, we have concluded that you do not qualify for exemption under Code section 501(c)(3). The basis for our conclusion is set forth below.

**Issues**

- Have you failed to demonstrate that you meet the operational test by operating exclusively for an exempt purpose under section 501(c)(3) of the Code?  
Yes, for the reasons stated below.
- Do your operations serve the private benefit of for-profit enterprises which would preclude exemption under section 501(c)(3) of the Code?  
Yes, for the reasons stated below.

Letter 4036 (CG) (11-2005)  
Catalog Number 47630W

- Do you qualify for tax exemption under section 501(c)(3) of the Code?  
No, for the reasons stated below.

## **Facts**

You were incorporated in the state of O on U.

Your Articles of Incorporation state that your purpose is to provide public education outreach materials to encourage water conservation.

Your bylaws state that your purpose is to provide outreach and materials to encourage water conservation in its various forms in Southeast O. Your bylaws further state that you carry out your purposes Using experienced (retired) teachers to develop and present your educational materials and programs, and by utilizing a variety of educational tools, you conduct (both public and private) grade and middle school assemblies and co-host garden club, home owner association and a variety of other community events. You also conduct educator, Municipal Utility District (MUD) director, and community leadership workshops. You believe your unique approach, combining education and entertainment, "edu-tainment", with a focus on young people, will foster a lifelong understanding of the importance of using water wisely."

You solicit funds for your programs from Municipal Utility Districts (MUDs), regional water authorities, water utilities, supporting water management, engineering and law firms, and other "water conscious" entities and individuals. In addition, you eventually plan to apply for grants from the State government and other sources.

Your board is composed of B, C, and D. B is President of your board and also is managing partner and majority owner of a for-profit company called P, which publishes and distributes educational materials dealing with water conservation. B is also President and sole owner of another for-profit company called Q, a consulting firm that provides print and electronic messaging as well as outreach programs, education programs, and newsletters to clients. Q sells products and services dealing with water conservation education in O.

D is a director and CFO of your board and also the Chief Financial partner of P, in which D owns the minority interest. In addition, D is an author who wrote the curriculum marketed and sold by P to be used for water conservation education in public schools. Finally, C serves as the third director on your board. C is also the chair for another nonprofit organization that specializes in water conservation. C is unrelated to B and D and has no ownership interest in P.

Your board shares common control with the for-profit corporation, P. As noted earlier, B owns the majority interest in P, and D owns the minority interest in P. P is an S Corporation based in R which specializes in water conservation education, program development and publishing. P sells books, coloring books, billing inserts, and brochures dealing with water conservation in O. Authors and illustrators own the copyrights and royalties to the publications sold by P. Both B and D have written and produced intellectual property dealing with water conservation education that are marketed and sold by P. B and D own the copyrights and, in some cases, the royalty rights on the intellectual property that they developed, published and now market through P.

P sells this intellectual property to three main categories of customers through both a retail and wholesale pricing system: the general public, which pays "list price" for publications and constitutes a very small part of P's total sales revenue, Tax-exempt Municipal Utility District (MUD) River Authority and Water Authorities – Governmental units or other nonprofit corporations involved in water conservation, and private companies such as engineering firms, law firms, water management companies, and other private entities wishing to underwrite the water conservation education programs by making "grants" to cover the purchase, placement and distribution of student materials for public and private schools.

P was formed to carry out an educational program of the local water authorities called M. The M program consisted primarily of P delivering donor-supplied materials to educators who used the materials in their classrooms (subsequently supported, in part, by a mobile water lab which is also owned by P). All educational materials were supplied free of charge on behalf of generous donors. The Mobile Teaching Lab became a part of the program as a traveling exhibit to the schools. As in the case of educational materials, donor funds were solicited to buy and build a teaching lab, which again, was provided at no cost to area schools. The actual conduct of conservation education was left in the hands of school classroom educators. P's role was focused on fundraising and the creation, preparation and delivery of materials.

You were created to take over the educational activities of P. You will be carrying out a new educational program called V, which has an emphasis on in-school assemblies and preparatory teacher workshops. Due to the new "materials/educator-based approach," you were designed to conduct the actual education of students and teachers, while P will continue to serve its traditional role as materials publisher and deliverer of products to the schools.

In your responses to our inquiries, you stated that you were formed for the following reasons:

- For-profit companies that are currently involved in purchasing products and services from P want to deal directly with a nonprofit corporation.
- You will potentially qualify for grant funding.
- Currently, for profit companies that purchase products and/or services from P are incurring a state sales tax on each transaction. If these same companies purchase their products and/or services from an organization that is tax exempt under section 501(c)(3), this sales tax will be eliminated.

You state that when you begin operating, your time and funds will be applied to funding water conservation education outreach efforts, collaborating with other similar organizations and foundations to hold public forums on the topic, and promoting local conservation initiatives (e.g. asking restaurants to serve water only on request). You will use mobile water labs and assembly programs where students will be exposed to interactive displays to learn about the "water footprint" of daily use patterns and products, and about the important role of composting and recycling in water conservation. These hands-on efforts will be supplemented by the distribution of billing inserts, resident brochures and public presentations that encourage the efficient use of water. You will work in cooperation with volunteers, local water authorities, municipal utility districts, consultants, educators, and civic and community groups.

You state that you will not contract with P or Q for products or services. However, you will purchase products from P. You project that approximately 15-20% of P's revenues, on an annual basis, will be derived from your purchases. All products that you purchase from P will include a mark-up of Y per item to accommodate P's profit margin.

You are funded exclusively through donations. Some donations are directed by the donor to cover school assemblies, workshops and/or donations of educational materials at particular schools. Your primary expense is the purchase and distribution of P's educational materials. You project that most of your total annual expenses (almost two thirds) will be incurred as a result of these activities. Specifically, you project that more than a quarter of your annual income will be spent on purchases of educational materials from P, and your budgets reflect that more than one third of your total annual expenses will be incurred on the distribution of educational materials. Staff compensation accounts for about one third of your annual expenses. Other expenses represent payments for professional fees and fundraising.

## **Law**

Section 501(c)(3) of the Code provides, in part, for the exemption from Federal income tax for organizations organized and operated exclusively for charitable, religious or educational purposes, no part of the net earnings of which inures to the benefit of any private shareholder or individual.

Section 1.501(c)(3)-1(a)(1) of the Income Tax Regulations states that in order to be exempt as an organization described in section 501(c)(3), an organization must be both organized and operated exclusively for one or more of the purposes specified in such section. If an organization fails to meet either the organizational test or the operational test, it is not exempt.

Section 1.501(c)(3)-1(c)(1) of the Regulations provides that an organization will be regarded as "operated exclusively for one or more exempt purposes only if it engages primarily in activities which accomplish one or more such exempt purposes specified in section 501(c)(3) of the Code. An organization will not be so regarded if more than an insubstantial part of its activities is not in furtherance of an exempt purpose.

Section 1.501(c)(3)-1(c)(2) of the Regulations provides that an organization is not operated exclusively for one or more exempt purposes if its net earnings inure in whole or in part to the benefit of private shareholders or individuals.

Section 1.501(c)(3)-1(d)(1)(ii) of the Regulations states that an organization is not operated exclusively for one or more exempt purposes unless it serves a public rather than a private interest. It must not be operated for the benefit of designated individuals or the persons who created it. Thus, to meet the requirement of this subdivision, it is necessary for an organization to establish that it is not organized or operated for the benefit of private interests such as designated individuals, the creator or his family, shareholders of the organization, or persons controlled directly or indirectly, by such private interests.

Revenue Ruling 66-104, 1966-1 CB 135 held that a nonprofit organization which makes funds available to authors and editors for preparing teaching materials and writing textbooks, and under the terms of the contract with the publisher, receives royalties from the sales of the published materials and then shares them with the individuals, did not qualify for tax exemption under section 501(c)(3) of the Internal Revenue Code. The revenue ruling stated the following: "Although educational interests are served by the publication of better teaching materials, the facts in this case show only an enterprise conducted in an essentially commercial manner, in which all the participants expect to receive a monetary return."

Better Business Bureau of Washington D.C., Inc. v. United States, 326 U.S. 279 (1945), held that the presence of a single nonexempt purpose, if substantial in nature, will preclude tax exemption under section 501(c)(3) of the Code.

In Est of Hawaii v. Commissioner, 71 T.C. 1067 (1979), several for-profit est organizations exerted significant indirect control over Est of Hawaii, a nonprofit entity, through contractual arrangements. The Tax Court concluded that the for-profits were able to use the nonprofit as an "instrument" to further their for-profit purposes. Neither the fact that the for-profits lacked structural control over the organization nor the fact that amounts paid to the for-profit organizations under the contracts were reasonable affected the court's conclusion that Est of Hawaii did not qualify as an organization described in section 501(c)(3) of the Code.

In Church by Mail, Inc. v. Commissioner (1985), the Court affirmed a Tax Court decision (T.C. 1984-349). Church by Mail sent out sermons in numerous mailings. This required a great deal of printing services. Twentieth Century Advertising Agency provided the printing and mailing. Twentieth Century was controlled by the same ministers. It also employed family members. The services were provided under two contracts. The contracts were signed by the two ministers for both Church by Mail and Twentieth Century. Church by Mail business comprised two-thirds of the business of Twentieth Century. In deciding for the government, the Court made the following statement: "There is ample evidence in the record to support the Tax Court's finding that the Church was operated for the substantial non-exempt purpose of providing a market for Twentieth's services."

In International Postgraduate Medical Foundation v. Commissioner, TCM 1989-36 (1989), the Tax Court considered the qualification for exemption under section 501(c)(3) of the Code of a nonprofit corporation that conducted continuing medical education tours. The petitioner had three trustees: Mr. Helin, who was a shareholder and the president of H & C Tours, a for profit travel agency, Mr. Regan, an attorney, and a third director, who was ill and did not participate. Mr. Helin served as executive director. The petitioner used H & C Tours exclusively for all travel arrangements. There is no evidence that the petitioner ever sought a competitive bid. The Court found that a substantial purpose of the petitioner was benefiting the for-profit travel agency. It concluded that: "When a for-profit organization benefits substantially from the manner in which the activities of a related organization are carried on, the latter organization is not operated exclusively within the meaning of section 501(c)(3), even if it furthers other exempt purposes." The court found that a substantial purpose of the applicant's operations was to increase the income of H&C Tours. H&C Tours benefits from the distribution and production of brochures which solicit customers for tours arranged by H&C Tours.

## Application of Law

You are not described in sections 501(c)(3) of the Code and sections 1.501(c)(3)-1(c)(1) and 1.501(c)(3)-1(a)(1) of the Regulations because you are not organized and operated exclusively for a charitable purpose.

You do not meet the requirements of section 1.501(c)(3)-1(d)(1)(ii) of the Regulations because you serve the private interests of B and D.

You do not meet the requirements of section 1.501(c)(3)-1(c)(2) of the Regulations because your earnings inure to the benefit of B and D.

You do not meet the operational test under section 501(c)(3) of the Code because your earnings inure to B and D through the purchase of P's educational materials and the payment of royalties on these materials to some of your board members. You were created by P, a for-profit company with which you share common control, to shift P's for-profit clients to a nonprofit entity thereby eliminating sales taxes currently incurred on the sale of P's educational materials. Ultimately, your purposes and operations serve the private interests of B and D, as well as their for-profit enterprises, P and Q, rather than public interests. As a result, you do not meet the requirements for tax exemption under section 501(c)(3).

You are similar to the organization described in Rev. Rul. 66-104 because you are substantially involved in the purchase and distribution of educational materials published and distributed by P through commercial sales transactions which result in increased profits to P and royalties paid to some of your board members. Your sales transactions serve the private interests of P and result in inurement of earnings to B and D. As a result, tax exemption under section 501(c)(3) of the Code is precluded.

You are operated for the substantial nonexempt purpose of providing water conservation educational materials for sale to private companies with earnings inuring to B and D. Better Business Bureau of Washington D.C., Inc. v. United States, 326 U.S. 279 (1945), held that the presence of a single nonexempt purpose, if substantial in nature, will preclude tax exemption under section 501(c)(3) of the Code.

In Est of Hawaii, the Tax Court concluded that for-profit corporations were able to use the nonprofit as an "instrument" to further their for-profit purposes. Like the for-profit Est organizations in Est of Hawaii, P is using you as an "instrument" to further P's for-profit purposes. You stated in correspondence that P created you so that the for-profit companies that currently purchase products and services from P could purchase P's products directly from a nonprofit corporation thereby eliminating a sales tax liability which P is currently required to charge to private companies and individuals. Like the est organizations described in EST of Hawaii, P substantially benefits from your operations.

In Church by Mail, supra, the Church argued that the compensation to the for-profit was



reasonable. The Court's statement on the subject is very significant. The Church exaggerates the importance of the contracts. The critical inquiry is not whether particular contractual payments to a related for-profit organization are reasonable or excessive, but instead whether the entire enterprise is carried on in such a manner that the for-profit benefits substantially from the operation. Like Church by Mail, your water conservation education program is carried on in such a manner that the for-profit, P, benefits substantially from your operations.

You are similar to the organization described in International Postgraduate Medical Foundation v. Commissioner, supra, because P and, by extension, B and D, benefit substantially from the manner in which your activities are carried on. Your Board of Directors and P's Board of Directors are controlled by the same individuals, B and D. P created you to take over the sales of P's educational materials to private companies in order to eliminate the state sales tax charged on each sales transaction. Your primary expense involves the purchase and distribution of educational materials exclusively from P at retail rates, which include royalty payments to D. Both B and D are privately benefiting from your operation, with profits inuring to P and, by extension, directly to B and D.

### **Applicant's Position**

You have chosen to decline the invitation to submit a statement of your position.

### **Conclusion**

Based on the information presented in your application as well as the attachments thereto, you do not qualify for tax exemption under section 501(c)(3) of the Code because you do not meet the operational test outlined in section 1.501(c)(3)-(1)(c)(1) of the Regulations. Furthermore, section 1.501(c)(3)-1(c)(2) of the Regulations provides that an organization will not be regarded as "operated exclusively" for one or more exempt purposes if its net earnings inure in whole or in part to the benefit of private shareholders or individuals. Based on the information provided, it is clear that net earnings inure to your board members, B and D, through the purchase of educational materials at discounted commercial rates from P, the for-profit entity they own and operate, and through royalty payments made to your board members on these purchases. Your budgets indicate that these payments, approximately two thirds of your total expenses, represent the costs associated with the purchase (directly from P) and the distribution of P's educational materials.

As a result, you are not operated exclusively for public rather than private purposes. Despite any educational purposes your activities may achieve, you cannot qualify for tax exemption under section 501(c)(3) of the Code because more than an insubstantial part of your activities are not in furtherance of exempt purposes.

Accordingly, you do not qualify for tax exemption under section 501(c)(3) of the Code because you do not meet the descriptions outlined in the Code and Regulations.

You have the right to file a protest if you believe this determination is incorrect. To protest, you must submit a statement of your views and fully explain your reasoning. You must submit the statement, signed by one of your officers, within 30 days from the date of this letter. We will consider your statement and decide if the information affects our determination. If your statement does not provide a basis to reconsider our determination, we will forward your case to our Appeals Office. You can find more information about the role of the Appeals Office in Publication 892, *Exempt Organization Appeal Procedures for Unagreed Issues*.

Types of information that should be included in your appeal can be found on page 2 of Publication 892, under the heading "Regional Office Appeal". These items include:

1. The organization's name, address, and employer identification number;
2. A statement that the organization wants to appeal the determination;
3. The date and symbols on the determination letter;
4. A statement of facts supporting the organization's position in any contested factual issue;
5. A statement outlining the law or other authority the organization is relying on; and
6. A statement as to whether a hearing is desired.

The statement of facts (item 4) must be declared true under penalties of perjury. This may be done by adding to the appeal the following signed declaration:

"Under penalties of perjury, I declare that I have examined the statement of facts presented in this appeal and in any accompanying schedules and statements and, to the best of my knowledge and belief, they are true, correct, and complete."

Your appeal will be considered incomplete without this statement.

If an organization's representative submits the appeal, a substitute declaration must be included stating that the representative prepared the appeal and accompanying documents; and whether the representative knows personally that the statements of facts contained in the appeal and accompanying documents are true and correct.

An attorney, certified public accountant, or an individual enrolled to practice before the Internal Revenue Service may represent you during the appeal process. If you want representation during the appeal process, you must file a proper power of attorney, Form 2848, *Power of Attorney and Declaration of Representative*, if you have not already done so. You can find more information about representation in Publication 947, *Practice Before the IRS and Power of Attorney*. All forms and publications mentioned in this letter can be found at [www.irs.gov](http://www.irs.gov), Forms and Publications.

If you do not file a protest within 30 days, you will not be able to file a suit for declaratory judgment in court because the Internal Revenue Service (IRS) will consider the failure to appeal as a failure to exhaust available administrative remedies. Code section 7428(b)(2) provides, in part, that a declaratory judgment or decree shall not be issued in any proceeding unless the Tax Court, the United States Court of Federal Claims, or the District Court of the United States for

the District of Columbia determines that the organization involved has exhausted all of the administrative remedies available to it within the IRS.

If you do not intend to protest this determination, you do not need to take any further action. If we do not hear from you within 30 days, we will issue a final adverse determination letter. That letter will provide information about filing tax returns and other matters.

Please send your protest statement, Form 2848, and any supporting documents to the applicable address:

**Mail to:**

Internal Revenue Service  
EO Determinations Quality Assurance  
Room 7-008  
P.O. Box 2508  
Cincinnati, OH 45201

**Deliver to:**

Internal Revenue Service  
EO Determinations Quality Assurance  
550 Main Street, Room 7-008  
Cincinnati, OH 45202

You may fax your statement using the fax number shown in the heading of this letter. If you fax your statement, please call the person identified in the heading of this letter to confirm that he or she received your fax.

If you have any questions, please contact the person whose name and telephone number are shown in the heading of this letter.

Sincerely,

Lois G. Lerner  
Director, Exempt Organizations

Enclosure, Publication 892